Summary Notes of the roundtable discussion entitled:

"The Relation between International Trade Margins and the Exchange Rate: The Case of Egypt"

Held at ECES on Wednesday, November 8, 2017

The Egyptian Center for Economic Studies (ECES) has always been keen to support economic decision-making in Egypt. Aiming to bridge the research gap on the response of the different sectors to changes in the exchange rate and to capture the resulting impact, benefits and damages, ECES commissioned Dr. Chahir Zaki to conduct the research, whose findings were presented in this RTD. Two in-house researchers, Mai Ehab and Aliaa Abdullah, participated in the development of this research

Presented by:

Chahir Zaki, Associated Professor of Economics, Faculty of Economics and Political Sciences, Cairo University

Discussants:

- Dr. Ibrahim Badawi, Managing Director, Economic Research Forum
- Mr. Hany Genena, Assistant Sub-Governor, Banking Reform Sector, CBE
- Eng. Tarek Tawfik, Vice Chairman, ECES

Moderator:

Dr. Abla Abd El-Latif, Executive Director and Director of Research, ECES

Main Points:

- The study aimed at identifying the effect of the exchange rate on trade margins in Egypt through a time series of firm-level export data during the period 2005-2016, using a standard gravity model methodology.

- There are two types of trade margins, namely, intensive and extensive margins. They are distinguished according to products, exporting firms and target markets. Exports through any of the firms originally exporting traditional products to traditional markets are intensive margins. Extensive margins are the new exports whether in terms of products, target markets or exporting firms.

- **The main findings of the study can be summarized as follows:**

  With respect to the reasons for Egypt's export growth, which amounted to about 19 percent during the study period, it is worth noting that increased global demand contributed to the growth of exports by 48.8 percent followed by specialization in some products (8 percent). Geographic allocation of export destinations and competitive countries account for -6 percent and -32 percent, respectively. Data showed a decline in the number of traditional export destinations as other competitive countries emerged. Traditional products have increased in some countries.

  - In the Egyptian case, the exchange rate depreciation positively affects the intensive margins through price rather than quantity. This can be explained by:
    - Lower price elasticity of exports
    - High import content of exports
    - Elastic domestic demand for imports
    - Elastic demand of the trading partners and their economic status
    - Raising the profit margin in an attempt to benefit from the devaluation
    - Firm reluctance to improve their production efficiency simply because they have the advantage of low prices, affecting competitiveness

  - For extensive margins, the number of products and countries increased as the local currency depreciated

  - The impact of the exchange rate varies by product and export destination.

  - The study divided Egyptian exports into four groups according to the comparative advantage and response to change in the exchange rate:

    - **Group 1:** low comparative advantage and response to changes in the exchange rate (41 products representing 9 percent of Egypt's exports), and therefore these products should be excluded from export subsidies

    - **Group 2:** high comparative advantage and exchange rate response (18 products representing 56 percent of total Egyptian export). These products should receive the greatest attention in order to benefit from the nominal depreciation.

    - **Group 3:** products affected by the exchange rate but Egypt does not have a comparative advantage therein (8 products representing 9 percent of exports). To deal with this group, focus should be placed on products that Egypt is about to have comparative advantage therein to impact the extensive margins. These products have been included in the Ministry of Industry and Foreign Trade's strategy.

- **Group 4:** Products that Egypt has comparative advantage therein but are not affected by the exchange rate. In this case, the role of complementary policies to maintain this comparative advantage is demonstrated.

The study recommended adopting complementary policies to the exchange rate policy to support the competitiveness of Egyptian exports; keep inflation in check to maintain a low real exchange rate; industrial policy by providing incentives and export subsidies; remove non-tariff barriers such as the number of days, improve labor efficiency, pay attention to foreign investments in order to bring in advanced production technology.

Main discussion points:

- Nominal exchange rate can be a tool for development not only for economic reform.
- The goal of exchange rate liberalization and export subsidies should be defined, whether it is to increase the dollar proceeds of the State or to promote growth and increase employment.
- Exchange rate liberalization or depreciation is either a policy or a crisis that requires remedy. In the Egyptian case, with the multiple events, it is usually a crisis. Therefore, it is preceded by a period of suffering affecting the production capacity and efficiency of the economy, followed by a stage of disorder until the restoration of balance. The recent crisis (which is considered a first generation currency crisis) did not allow enterprises to prepare for the opportunity availed by depreciation for export because of the lack of foreign exchange to import inputs and keep at the level of operational capacity.
- Certain external events, which coincided or followed the liberalization of the exchange rate, had a positive impact on exports. These include the political turbulence in Turkey or Lebanon that affected the industries in which these countries compete with Egypt, making Egypt the alternative. Also, regular gas supply to factories helped to revive production with full capacity for fertilizer and iron factories.
- One positive consequence of the exchange rate liberalization, other than exports and tourism, is that many enterprises revisited their business model, which depended on importing inputs, and targeted the domestic market to look for local suppliers, as well as attempt to target the foreign market. Positive consequences also include the tendency of migrating industries to discuss returning to Egypt (China's textile and garment industry); and training of Egyptian labor (due to low cost) and export thereof to countries that suffer from shortage of trained labor.
- Despite the negative impact of high interest rate on business costs, recurrent raising of the interest rate on the Egyptian pound and the high borrowing cost in local currency following the exchange rate liberalization in November 2016 prompted companies to seek borrowing in foreign currency (dollar) due to its low cost. This requires a foreign exchange cover (export receipts). Therefore, they increased exports.
- A dynamic model was suggested that can differentiate between the effect of short and long term exchange rate changes while extending the time range to post 2016. It was also

suggested to introduce variables that reflect the institutional aspect and change in the oil price and explore the possible consequences of changing the US monetary policy. Finally, adjusting the commodity level based on which products were classified from HS2 to HS4 was also suggested.

- Standard models provide space for quantitative assessment of the relationship between variables. However, each of these models has limits and drawbacks that must be taken into consideration in economic decision-making.